

result of implementation of FASB 106, because this [PBOPs] liability has been factored into our ratings."¹⁸ However, credit rating agencies clearly do intend to give PBOPs greater scrutiny when assessing corporate credit quality. More specifically, when SFAS No. 106 values and cash flow analyses indicate that PBOPs obligations represent a very substantial use of cash, the rating agencies will seek more information about the demographics of the workforce, insurance plan provisions, and the aggressiveness and effectiveness of management's health cost containment efforts. Also, rating agencies will take into account financial flexibility because plan assets, especially for nonregulated firms operating in competitive markets, are not easily reverted from one use to another. If this additional analysis reveals PBOPs liabilities exceed expectations, then credit analysts may review the issue with management and a credit downgrading may result.

Equity Values: Brokers and shareholders are concerned that the implementation of SFAS No. 106 may cause stock prices to fall. However, according to Salomon Brothers, "We do not expect the adoption of FASB 106 to adversely affect stock prices of most companies because there is no direct cash flow impact. In general, the stock market ignores pure accounting changes. When earnings fail to present an accurate measure of cash flow performance, it is cash profitability -- not accounting profits -- that appears to be the market's dominant criterion for assessing economic value."¹⁹

Funding: Without a doubt the major issue for prefunding PBOPs is the availability of tax deductible investments. Funding which is not tax deductible is not cost effective because

18. **Moody's Special Comments, FAS 106 -- Moody's Analytical Perspective, March 1991.**

19. **The Financial Executive's Guide to Retiree Medical Benefits (How to Survive the Big Bang of Accounting Standards), pg. 8, Lawrence N. Bader and Peter B. Blanton, published by Salomon Brothers, July 1991.**

employers are also burdened with income taxes on the contribution amount. Most significantly, IRS/ERISA treats PBOPs on a cash or pay-as-you-basis rather than on an accrual basis; therefore, unlike pensions, there are no incentives and indeed there are severe limitations on prefunding PBOPs. In fact, the conventional wisdom is that existing public policy discourages prefunding to the extent that existing tax incentives are inadequate to accommodate actual funding requirements. As a result, it seems that major companies are not prefunding PBOPs.²⁰

For most companies (i.e., those that are less than triple-A rated), prefunding will cause a wealth transfer to PBOPs claims from other unsecured financial claims against the employer. More precisely, by funding PBOPs via legally segregated assets, the value of plan participants' claims against the company is improved (i.e., the PBOPs obligation becomes secured) at the expense of unsecured bondholders, shareholders, creditors and other investment opportunities. Furthermore, prefunding PBOPs may also affect positive results, such as a better matching of assets and liabilities, lower costs in the long run attributable to cumulating tax-free earnings on investments, and improved employee morale due to increased probability that the PBOPs will be paid. However desirable these transfers of wealth and other benefits may be, the **economic** decision to prefund should be based on a quantitative analysis of present value calculations of the long term rate of return of investment alternatives. In order to capture the true economic values of competing funding alternatives, this analysis must include separately risk-adjusted discount rates to the respective funded and unfunded

20. The Financial Executive's Guide to Retiree Medical Benefits (How to Survive the Big Bang of Accounting Standards), pp. 10 and 11, Lawrence N. Bader and Peter B. Blanton, published by Salomon Brothers, July 1991. "Retiree Medical Liabilities and FAS106", pg. 36, **Standard & Poor's Creditweek**, May 20, 1991.

obligations.²¹ Last, but not least, funding levels should be limited to the point where the marginal benefits and costs are equal.

This concludes the background to DRA's Phase II Comments. The generic issues and topics discussed in this section constitute the scope of and springboard for all DRA's analysis and recommendations on the Phase II issues (I.90-07-037, pp.6-7, and Ordering Paragraphs 5 and 6; D.91-07-006, Ordering Paragraphs 6 and 9) addressed in this document.

III. PHASE II ISSUES

1. Consideration and Adoption of SFAS No. 106 for Ratemaking Purposes

A. Adoption of Pay-As-You-Go Accounting for Ratemaking Purposes Is The Optimal Course Of Action

DRA recommends pay-as-you-go (PAYGO) for both regulatory accounting and ratemaking purposes²². DRA does not quarrel with

21. SFAS No. 106 requires the use of a high-quality fixed-income market rate to discount PBOPs liabilities (SFAS No. 106, paragraph nos. 186-194). However, this is not appropriate for valuating unfunded obligations of companies with less than triple-A credit ratings. Therefore, SFAS No. 106 reporting does not produce accurate estimates of unfunded PBOPs liabilities because high-quality, fixed-income rates do not reflect the economic value of the risk associated with unsecured debt or the extremely extended PBOPs' payment schedule (55 to 75 years).

22. PAYGO is consistent with IRS/ERISA law regarding accounting and funding for PBOPSS. IRS/ERISA refers to the Employee Retirement Income Security Act of 1974 and related amendments thereto: the Multiemployer Pension Plan Amendments Act of 1980, the Retirement Equity Act of 1984, the Single-Employer Pension Plan Amendment Act of 1986, and certain sections of the Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1987, the Tax Reform Act of 1989, and others. Although IRS/ERISA does not require employers to establish or maintain employee

(Footnote continues on next page)

the concept of prefunding or with the practice of accrual accounting. DRA only seeks to ensure that the adopted funding and accounting truly reflect how PBOPs are provided, are the most efficient means of rate recovery, and are the most prudent course of action given the risks and uncertainties attendant to PBOPs markets. DRA concludes that PAYGO is superior in all respects to the alternatives.

Economics clearly dictate that PAYGO is the most efficient approach and provides the most benefits to ratepayers. DRA's quantitative analyses demonstrate that 1) pay-as-you-go funding is the most economically sound and justifiable approach (Appendix 3); 2) prefunding is not as cost effective (on a net present value basis) as pay-as-you-go funding (Appendix 2 and 4); and 3) nontax-deductible prefunding is uneconomic and unsound (Appendix 3). The fact that PAYGO is less expensive than prefunding is attributable to the enormous increase in the PBOPs funding obligation attendant to accrual accounting which overwhelms the benefits of the tax-free accumulated earnings on assets.

Utilities proposing recovery beyond PAYGO have the burden of clearly demonstrating, via rigorous quantitative analysis, that on a present value basis such funding results in the lowest costs (including the cost of capital) of all alternatives. In making this demand, DRA must also insist that the results and conclusions regarding funding beyond PAYGO be based on quantitative analyses and not assumed outcomes. To base funding decisions on unsubstantiated assumptions is imprudent and can

(Footnote continued from previous page)

benefit plans, it does provide certain standards for employer expenditures on employee benefits to qualify as tax deductions and for minimum and maximum limitations on those deductions. More specifically, it sets forth certain standards for participation and vesting, funding limitations, fiduciary responsibilities, disclosure requirements, and termination insurance for established pension plans. The Internal Revenue Service, the Department of the Treasury, the Department of Labor, and the Pension Benefit Guarantee Corporation are required to interpret and enforce IRS/ERISA.

result in unnecessary harm to ratepayers. So far, none of the utilities has met its burden of justifying any revenue requirements beyond PAYGO.

Adoption of DRA's recommendation has the following additional advantages:

1. New Legislation -- SFAS No. 106 will provide employers and employees with additional ammunition to lobby legislators for more tax incentives. It will add to the existing pressures for federal relief/intervention. Adoption of a conservative PAYGO approach to funding PBOPs will give regulators and utilities the opportunity to assess these developments and choose the optimal course of action.

2. Labor/Management -- SFAS No. 106 is giving employers, employees, regulators, and legislators cause to more closely scrutinize PBOPs and obtain more reliable information with which to address legal issues, health cost containment, and bargaining disputes. Adoption of a conservative IRS/ERISA approach to funding PBOPs will give regulators and utilities more time to assess these developments and choose the optimal course of action.

3. Accounting -- IRS/ERISA tax accounting standards are designed with greater flexibility for determining expense and liabilities. This is attributable to plan sponsors' need to have more discretion and opportunities to fund benefit obligations, especially for collectively bargained plans. Adoption of IRS/ERISA accounting for ratemaking purposes will provide this Commission and the utilities with more flexibility with which to fund PBOPs.

4. More protections for ratepayers and employees -- The FASB does not intend to and does not have any authority to regulate PBOPs. Therefore, SFAS No. 106 was not constructed with funding safeguards and employee benefit protection in mind. These objectives fall under the jurisdiction of IRS/ERISA and the Department of Labor. To ensure that protection exists for regulated utility operations and to minimize regulatory burden, this Commission, ratepayers, and employees would do well via the adoption of PAYGO accounting. Furthermore, this prudent approach

will provide greater flexibility for responding to new legislation and developments in labor/management relations.

5. Lower regulatory burden -- If no new accounting standard or tax treatment is adopted, then there is no justification for Z Factor treatment for Pacific and GTEC, and no need to begin reconciling the SFAS No. 106 revenue requirement with PAYGO/IRS/ERISA tax accounting. Thus, telecommunication utilities could prefund PBOPs at their own discretion, as their funding capabilities and financial position allows.

**B. Changes in GAAP Do Not Automatically Mandate
Changes in Accounting For Ratemaking Purposes**

There is no requirement that GAAP be used to set rates. This fact is recognized by GAAP in Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation (SFAS No. 71).

The CPUC's stated policy has been to adopt changes in GAAP for ratemaking purposes on a case-by-case basis (D.87-12-063). Indeed, this proceeding is testimony to the fact that this Commission does not routinely adopt GAAP for ratemaking.

GAAP was never intended by its architects to be used for setting rates and can be ill-suited for that purpose. The Commission's case-by-case approach to adopting GAAP for ratemaking is based on the Commission's recognition that good accounting does not necessarily constitute good ratemaking. Accordingly, the salient issue in this proceeding is not whether SFAS No. 106 is good accounting (it is), but whether SFAS No. 106 is good ratemaking. The answer can be found in SFAS No. 106 itself. As the following excerpt from SFAS No. 106 demonstrates, SFAS No. 106 was never intended to be used as a standard by which to judge the soundness of PBOPs funding decisions:

"The decision of how or when to fund the obligation is not an accounting issue. It is a financing decision that is properly influenced by many factors (such as tax considerations and the availability of attractive investment alternatives) that are unrelated to how or when the postretirement benefit obligation is incurred." [SFAS No. 106, Paragraph 150]

As the above excerpt from SFAS No. 106 illustrates, the proper accounting for PBOPs costs and obligations has little to do with the optimal financing (or ratemaking) of the same costs and obligations.

There are literally dozens of examples of the Commission pursuing sound and prudent ratemaking at the expense of adherence to Generally Accepted Accounting Principles (GAAP). Taxes are a good example. To the extent allowed by Federal law, the

Commission has decided that utility-paid taxes should be included in rates in the same year that the utility actually pays the taxes. If the Commission had instead followed GAAP, taxes could be included in rates either before or after the year in which the utility actually pays the taxes. Additional examples of the Commission's departure from GAAP for ratemaking purposes are listed below:

- Pension Expense (SDG&E, Pacific Bell, GTEC, Edison, PG&E)
- South Bay Clean Air Demonstration Project (SDG&E)
- Combined-Cycle Project (SDG&E)
- Haber Sales Support and Litigation Costs (SDG&E)
- Intervenor Compensation (SDG&E)
- Songs Nuclear Design Basis Documentation Costs (SDG&E)
- Incentive Awards (Pacific Bell)
- Compensated Absence (Pacific Bell)
- Workers Compensation (Pacific Bell, PG&E)
- Equal Access (Pacific Bell)
- Bond Redemption (Pacific Bell, PG&E)
- 900/976 Blocking Costs (Pacific Bell)
- Interest During Construction (Pacific Bell, GTEC)
- Allowance for Funds Used During Construction (PG&E)
- Diablo Canyon (PG&E)
- Customer Energy Efficiency Resources (PG&E)
- Customer Energy Efficiency Program - Incentives (PG&E)
- El Paso Deferred Costs (PG&E)
- Unamortized Debt Expense (PG&E)
- Lifeline Adjustment Plan (PG&E)
- Investment in Women's Minority Business (PG&E)
- Palo Verde Phase-In Plan (Edison)
- Regulatory Balancing Accounts: ECAC, FCA, ERAM, Helms, Lira, CFA, PGA-Core, CFCA-Core, Transition Cost-Core Take or Pay, Transition Cost-Noncore, DER, Interutility Account, Pilot Banking Reservation Fee, DNTA, Brokerage Fee Account, GFCA-Noncore, NGVBA, Firm Surcharge, GEDA, Steam.

Many of the reasons behind the Commission's decision to forgo GAAP in the above examples are also applicable to SFAS No. 106. For instance, the Commission chose not to adopt GAAP for pensions in part because GAAP cannot be used to fund a utility's pension plan;²³ and because the Commission found unreasonable the method by which GAAP assigns pension costs to each period.²⁴ SFAS No. 106 cannot be used to fund a utility's PBOPs, either, and should be rejected for that reason. Likewise, since SFAS No. 106 assigns pension costs to each period in a manner similar to that rejected by the Commission for pensions, SFAS No. 106 should also be rejected for ratemaking purposes.

The Commission rejected GAAP for income taxes because it makes little sense to set rates on a basis other than what taxes the utilities actually pay. The same principle holds true in the case of PBOPs, namely, that rates should be based on what the utilities actually pay, not the hypothetical costs (i.e., the "Substantitive Plan" rather than the actual labor contracts) computed by accountants.

As the many examples above demonstrate, there is more than ample precedent for rejecting the use of GAAP for ratemaking. What emerges from the above examples is the clear precedent that ratemaking should be done a reasonable basis regardless of GAAP. Since SFAS No. 106 does not produce reasonable and reliable economic costs, it must be rejected for ratemaking purposes.

C. Applicability of Using SFAS No. 71 to Offset SFAS No. 106 Obligations

1) Description of SFAS No. 71

SFAS 71 provides guidance in preparing general purpose financial statements by public utilities. For a number of reasons, regulators will allow recovery of costs by utilities in a time period different from the one when such costs must be recognized in the income statement under GAAP. In other words,

23. D.88-03-072, page 11 and Finding of Fact No. 15

24. D.88-033-072, page 11.

revenues intended for the recovery of costs can be provided for in rates either before or after the costs are actually incurred by the utility. If regulators provide assurance that already incurred costs will be recovered in the future, SFAS 71 requires utilities to capitalize those costs. The new asset (commonly referred to as a regulatory asset) represents future cash inflows that will result from the rate-making process. Conversely, if current rates provide for costs that are expected to be incurred in the future for financial reporting purposes, SFAS 71 requires utilities to recognize those current cash inflows as liabilities.

To the extent current costs are capitalized as a regulatory asset, such costs do not flow through the income statement. In other words, the greater the amount of SFAS No. 106 costs that a utility capitalizes as a regulatory asset under SFAS 71, the smaller the current impact of SFAS No. 106 on the utility's net income. Later, as PBOPs costs recognized for ratemaking purposes exceed SFAS No. 106 costs, the process will reverse itself. The net result is only a change in the timing of the recognition of SFAS No. 106 costs, and not the amount of costs.

There are two tests that must be met in order for a timing difference between ratemaking and GAAP to qualify as a regulatory asset. First, it must be probable that the full amount of the capitalized regulatory asset will be recovered by the utility in future rates. Second, future revenues must provide for the recovery of previously incurred costs of the regulatory asset rather than the expected levels of similar future costs.

The FASB explicitly recognizes the appropriateness of using SFAS 71 to account for SFAS No. 106 PBOPs costs. As stated in Paragraph 6 of SFAS No. 106: "For some rate-regulated enterprises, FASB Statement No. 71...may require that the differences between net periodic postretirement benefit costs as defined by this Statement [Statement No. 106] and amounts of postretirement benefit cost considered for rate-making purposes be recognized as an asset or a liability created by the actions of the regulator. Those actions of the regulator change the timing of recognition of net periodic postretirement benefit cost

as an expense; they do not otherwise affect the requirements of this Statement." Clearly, then, the FASB recognizes that GAAP do not preclude the CPUC from adopting a revenue requirement for PBOPs that differs from costs recognized under SFAS No. 106. To the contrary, FASB has set forth the accounting treatment required under these circumstances.

2) SFAS No. 71 Issues

There are three principle issues associated with SFAS No. 71, and they are: (i) the level of regulatory assurance needed to record a regulatory asset if the Commission does not allow full recovery of SFAS No. 106 costs; (ii) whether a SFAS No. 106-related regulatory asset should receive rate base treatment; and (iii) whether utilities operating under alternative regulatory frameworks can record SFAS No. 106-related regulatory assets.

a) Level of Regulatory Assurance Needed To Record a Regulatory Asset

Edison contends that it is doubtful whether it could obtain a level of "regulatory assurance" from the CPUC sufficient to convince the Securities and Exchange Commission (SEC) that a regulatory asset exists. Edison claims that it needs either an explicit "regulatory assurance" in the Phase II decision that guarantees deferred costs will be recovered, or in the alternative, full recovery of all SFAS No. 106 costs.

Edison's claims are based upon what it alleges to be a heightened level of concern by the SEC regarding the lack of substantive evidence presented by companies supporting the deferral of incurred costs under SFAS No. 71. According to Edison, it could take up to 40 years to recover deferred SFAS No. 106 expenses. Edison believes it is unlikely that the CPUC would provide "regulatory assurance" which would satisfy the SEC that such costs could be recovered decades from now.

DRA acknowledges that utilities' prudently incurred PBOPs obligations are a reasonable expense of doing business. As

stated elsewhere, DRA maintains that cost effectiveness is the standard by which recovery of PBOPs obligations should be judged reasonable or unreasonable. DRA believes that this standard of recovery provides sufficient "regulatory assurance" to enable utilities to record deferred SFAS No. 106 costs as a regulatory asset under the provisions of SFAS No. 71.

DRA's belief is supported by the SEC itself. DRA obtained the document relied upon by Edison in making its claim that the SEC may not allow deferred SFAS No. 106 costs to be recorded as a regulatory asset.²⁵ While the document does show a heightened level of SEC concern, the picture presented by Edison in its

Testimony is highly skewed if not misleading. In the same document relied upon by Edison is the following statement:

"The SEC staff believes that if the regulator has indicated they will allow the costs in rates on a pay-as-you-go basis, OPEB [PBOPs] accruals may qualify as regulatory assets."

In other words, it appears the SEC does not view formal CPUC pre-approval of recovery of SFAS No. 106 costs 40 years into the future as a prerequisite for the recording of a regulatory asset.

In any event, DRA does not believe that Commission policy should be driven by whether or not utilities can record a regulatory asset under SFAS No. 71. Rather, sound regulatory policy requires that recovery of PBOPs costs be driven by economic efficiency, cost effectiveness, and prudence. DRA recommends that the Commission not give Edison, or any utility, the blank check "regulatory assurance" being sought.

**b) Rate Base Treatment for Regulatory
Assets Created Pursuant to SFAS No. 106**

If the Commission rejects SFAS No. 106 for ratemaking, the utilities are divided as to whether the resulting regulatory

25. . See Pages 3-7 and 3-8 of Edison's Exhibit SCE-2

asset should receive rate base treatment. SDG&E says that it depends on whether or not it funds the regulatory asset. If SDG&E funds the regulatory asset, then it should be ratebased, and vice versa. Edison, PG&E, and SoCalGas all concur that rate base treatment would be inappropriate since the regulatory asset would not be funded.

Pacific Bell and GTEC, on the other hand, believe that a SFAS No. 106-related regulatory asset should receive rate base treatment with annual true-ups via a Z factor. Southwest Gas also believes the SFAS No. 106-related regulatory asset should receive rate base treatment.

DRA agrees with Edison, PG&E, and SCG that a SFAS No. 106-related regulatory asset should not receive rate base treatment. If the utilities are not funding the regulatory asset, there is no need to provide a return. More importantly, if the Commission determines that it is imprudent to fund SFAS No. 106 costs beyond some level, then ratepayers should not pay a return on funding in excess of the Commission prescribed level.

DRA recommends that the Commission order the utilities to not include a PBOPs regulatory asset in rate base without explicit authorization to do so.

c) Regulatory Assets for Utilities Operating In Alternative Regulatory Frameworks

The key requirement for a utility's accrual of a regulatory asset is the assurance by the regulator that the regulatory asset will be recovered in future rates. In many instances, there is no regulatory assurance that SFAS No. 106 costs will be recovered in future rates. For example, Pacific Bell and GTEC acknowledge that SFAS No. 106 costs related to their below-the-line services, such as voice mail and electronic mail, can never be recorded as a regulatory asset. These services are largely deregulated and thus lack any regulatory assurance that their costs will be recovered in current or future rates. PG&E's Diablo Canyon nuclear power plant is another example. SFAS No. 106 costs associated with Diablo Canyon can't be booked as a regulatory

asset since there is no regulatory assurance that any Diablo Canyon-related costs will be recovered in future rates.

The question of whether a PBOPs regulatory asset can be recorded by a utility under price cap regulation is not as easily answered. According to GTEC, utilities under price cap regulation (Pacific Bell and GTEC) have no assurance of future recovery of SFAS No. 106 costs and would thus be precluded from recording a regulatory asset under SFAS No. 71. Pacific Bell's position is not as certain. In a response to one data request, Pacific informed DRA that it was speculative as to whether Pacific could record a PBOPs regulatory asset. But in another data response, Pacific Bell states that SFAS No. 71 is applicable to PBOPs costs, even under price cap regulation.

DRA believes that ratemaking for PBOPs costs should not hinge on whether a utility can record such costs as regulatory asset. The appropriate standard for ratemaking is whether such costs are reasonable, and in the case of Pacific Bell and GTEC, whether such costs are a legitimate Z factor.

D. SFAS No. 106 Should Not Be Adopted For Ratemaking Purposes

DRA recommends that SFAS No. 106 not be adopted for ratemaking purposes. As stated earlier, it is simply not cost effective and not economically efficient to prefund the total SFAS No. 106-determined cost. Indeed, as shown in Appendices 2 and 3, to fully fund under SFAS No. 106 would be detrimental to the ratepayers when compared to DRA's recommended approach of using PAYGO. From a regulatory policy perspective, the uncertainties associated with PBOPs and the inaccuracies and volatility associated with SFAS No. 106 could result in imprudent ratemaking and serious harm to ratepayers. Furthermore, DRA has concluded that the adoption of SFAS No. 106 could result in severe market distortions because regulated monopolies would be assuming a market leadership role for an unresolved, controversial, and far-reaching issue. Without having withstood

the test of the competitive market place or having received public sanction via legislative debate, monopolies' demands may not reflect prevailing economic realities and may be out-of-touch with the nation's current social/political priorities. These aspects are discussed in detail in the paragraphs below:

1) Pay-As-You-Go Funding is the Most Cost-Effective

The most cost-effective way to fund PBOPs obligations is obtained with pay-as-you-go accounting (PAYGO). Funding beyond this level will not produce significant net ratepayer benefits over those currently enjoyed under PAYGO accounting (See Appendix 2). For various utilities, DRA has performed a numerical analysis comparing the present value of PBOPs PAYGO expenses against the two alternatives of "prefunding" PBOPs costs to the extent they are tax deductible, and full-funding of all SFAS No. 106 costs (See Appendix 4). DRA found that the present value of PAYGO is approximately 50.9% lower than partial funding and 51.3% lower than full SFAS No. 106 funding, even at a time frame of roughly 20 years. DRA concludes that PAYGO is the most cost-effective means for funding PBOPs and that any funding beyond PAYGO is uneconomic and cannot be justified on a net present value basis.

DRA's analysis is based upon the following data obtained from the respondent utilities: Each utility's forecast of its own PBOPs PAYGO, partial "prefunding," and full SFAS No. 106 funding. To compare the long-term relative cost to ratepayers of each of three PBOPs funding alternatives, DRA computed the present value of the utilities' forecasts. This analysis shows that present value of PAYGO is consistently and significantly less than the alternatives. (See Appendix 4.)

DRA used two different discount rates in its evaluation of the PBOPs funding streams: 1) average utility long-term debt rate, and 2) the given utility's expected authorized cost of capital. Traditionally, DRA has evaluated utility operating expense forecasts at the utility's incremental cost of capital. (Some parties argue that it is more appropriate to present value

forecasted PBOPs expenses at the lower utility long-term debt rate.) Under either discount rate assumption, the present value of PAYGO is consistently less than the alternatives.

Cash flow and net present value analyses present the truest comparison between ratemaking under SFAS No. 106 (i.e., accrual accounting) versus pay-as-you-go (i.e., cash accounting). Such analyses reveal the combined effects of all benefits and costs of each alternative ratemaking accounting on the ratepayer's pocket books. More specifically, the cash flow graphs and tabulations (Appendices 2 and 4) clearly show that it takes several decades for the pay-as-you-go cash stream to catch-up (i.e., "cross over") to the prefunding cash stream. The attendant tabulations for net present value compliment this finding by indicating that many more years must pass before the net present value of ratemaking under prefunding equals the net present value of pay-as-you-go ratemaking. From these two objective analyses, one is forced to conclude that it takes many decades before any conceivable net benefits can be expected from switching from pay-as-you-go ratemaking to accrual accounting with prefunding.

The reason for these results is three-fold. First, ratemaking under accrual accounting with prefunding multiplies the revenue requirement because revenues are collected over the working lives of active employees rather than as retiree medical claims are incurred. Secondly, full funding under SFAS No. 106 would result in PBOPs being fully funded upon the employee's retirement rather than funded as retiree claims are incurred. Therefore, since there are many more active employees than retirees, and claims must be fully funded before incurrence begins, ratemaking under accrual accounting is much more expensive than pay-as-you-go ratemaking. Lastly, there are no minimum cash flow requirements and no impact on creditworthiness attendant to accrual accounting (Appendix 5). Therefore, there are no dollar benefits attributable to defeasing the SFAS No. 106 liability.

DRA must note its concern about the uncertainty of the utilities' forecasted PBOPs expenses. Since utilities can reserve the right to reduce or eliminate their PBOPs programs,

health cost growth rates show considerable volatility and the notion of nationalized health care is gaining support, DRA believes that extending the time frame of this analysis in the hope of justifying prefunding PBOPs will produce unreliable results.

Adoption of SFAS No. 106 for ratemaking will result in huge increases in economic inefficiencies as ratepayer costs triple or quadruple with no increase in worker productivity or in the efficient provision of benefits. Furthermore, according to estimates from independent benefit research groups, it may take up to 50 years for pay-as-you-go accounting to exceed accrual accounting (i.e., under either the entry age normal or projected unit credit methods).²⁶ Most significantly, any net benefits which take decades to be realized are subject to the tremendous uncertainties and risks associated with retiree benefits (see footnote 9). If the net benefits are correctly weighted by the appropriate probabilities, then they become insignificant. Ratepayers should not be burdened under such flimsy justifications.

All of these net present value analyses show that the general consensus, even among regulated utilities, is that any conceivable net benefit attributable to switching to accrual accounting, with prefunding, will occur decades into the future. Given the controversies surrounding retiree health care coverage in legislatures, compensation markets, and tax law, it is doubtful that any such projections of net benefits can actually be guaranteed. To further complicate matters, future changes towards deregulation and away from cost-based regulation may preclude any assurance that ratepayers will receive the net benefits to which they are entitled.

26. Milliman & Robertson, Inc., Measuring and Funding Corporate Liabilities for Retiree Health Benefits (Washington, DC: Employee Benefit Research Institute, 1988), pp. xxxiv - xxxv.

2) SFAS No. 106 Results In Unsound Revenue Requirements

SFAS No. 106 will result in unsound revenue requirements. The SFAS accounting is not consistent with IRS/ERISA tax accounting. Generally speaking, the large SFAS square peg will not fit into the small IRS/ERISA round hole.²⁷ This predicament can place ratepayers and shareholders in jeopardy and may cause harm to ratepayers. More specifically, this may produce revenue requirements that are too large to invest in tax deductible funding vehicles. Shareholders and management will be forced to decide whether to squander funds on nontax-deductible PBOPs investments which are not cost effective and are unreasonable (see Appendix 3), to divert ratepayer funding to nonPBOPs uses, and/or violate IRS/ERISA funding limitations, thereby incurring fines (e.g., excise taxes). Furthermore, it is conceivable that, like SFAS No. 87, SFAS No. 106, sometime in the future, will result in credit amounts.²⁸ This will imply that PBOPs assets should revert back to ratepayers. This would result in

27. Paul Rosenfield, CPA, Accounting and Auditing for Employee Benefit Plans; Revised Edition, 1990 Cumulative Supplement (Boston, Massachusetts: Warren, Gorham, Lamont, Inc., 1990), pp. S13A-8--S13A-9.

Employee Benefit Research Institute Education and Research Fund, Retiree Health Benefits: What Is the Promise? (Washington, DC: Employee Benefit Research Institute, 1989), pp. 71-73.

Lawrence N. Bader and Peter B. Blanton, The Financial Executive's Guide to Retiree Medical Benefits (How to Survive the Big Bang of Accounting Standards). Salomon Brothers Inc., United States Financial Strategy Group; Retiree Medical Benefits, July 1991, pp. 10-11.

Retiree Benefits: Tackling a Complex Issue. Deloitte & Touche, 1990, pp.14-15.

28. GTEC reported a credit of over \$10 million under SFAS No. 87 for 1990 for total salaried and nonsalaried employees. Pacific Telesis reported a credit of over \$29 million under SFAS No. 87 for 1990 for its nonsalaried employees.

noncompliance and penalties under IRS/ERISA statutes (IRR § 1.401-2 and 1.401(a)-2). Finally, the interest rate assumptions and asset valuation methods prescribed by the FASB are different from those required under IRS/ERISA. This can result in penalties for overfunding and provides an incentive for the diversion of ratepayer funds to nonPBOPs uses.²⁹ Reasonable standards of prudence and fairness dictate that SFAS No. 106 be rejected for ratemaking purposes and that this Commission adopt ratemaking accounting that should not jeopardize ratepayer funding and cause serious harm to ratepayers.

3) FASB Does Not Intend for SFAS No. 106 to be Used For Funding Purposes

The FASB has gone on record to state that it does not intend for SFAS No. 106 to be used to determine funding levels (SFAS No. 106, paragraph no. 150). This Commission should follow this prudent and reasonable directive. Book entries that are used for reporting and comparison purposes at a point in time may not be valid for imposing enormous cost burdens on ratepayers. This is particularly true when the SFAS No. 106 financial obligation, by definition, is not legally binding (SFAS No. 106, paragraph no. 155-156), is subject to radical change from one period to the next (See footnote 9), and has questionable relevance for determining creditworthiness and equity value (See footnotes 15, 16, and 17). If the economic decision-makers in competitive markets are not using SFAS No. 106 to determine funding levels, why should captive customers in regulated markets be forced to do

29. FASB promulgates two different rates -- one for discounting and another for the rate of return on assets (SFAS No. 106, paragraph nos. 46, 48, 49). In addition, SFAS No. 106 (paragraph nos. 49-51) requires the use of the fair market value of assets as of a certain date for reporting purposes.

This is in sharp contrast to IRS tax statutes which require one interest rate assumption (IRC § 412(b)(5) and see examples IRR § 1.412(c)(1)-2(g)(6) through 1.412(c)(1)-2(k)) and preclude the use of the fair market value for the valuation of assets (IRR § 1.412(c)(1)(b)(2)).

so? (See fifth "Key Point", page 2 of the January 2, 1991 Bears Stearns article in Appendix 5; second to the last paragraph of the May 20, 1991 Standard & Poor's Creditweek in Appendix 5; and the 1990 Hewitt Associates Survey of PBOPs in Appendix 14.)

4) The "Obligation" Under SFAS No. 106 is Not Legally Binding And Does Not Reflect An Employer's Funding Obligation

The obligation as estimated under SFAS No. 106 is not legally binding and does not reflect an employer's funding obligation. Therefore, adoption of SFAS No. 106 for ratemaking purposes can result in a) the unfair and unreasonable treatment of ratepayers, b) no protection of PBOPs benefits earned by employees, and c) disincentives for pursuing health cost containment. First, it is obviously unfair and unreasonable to burden ratepayers with expenditures for "obligations" that are not legally enforceable. Secondly, because the assets are not vested³⁰, individual employees do not have a legal right to obtain them, especially, if they leave the company before retirement. Improvements in employee morale and productivity will not materialize because the individuals who have earned these benefits will soon find that under certain circumstances they are not entitled to them. Similarly, employers will soon find that since these PBOPs fundings are earmarked for benefits, not employees (i.e., PBOPs are not vested), prefunding will create disincentives for pursuing health cost containment. The incentive will be for employers to reduce or to overestimate obligations in order to obtain cash windfalls from the resulting excess revenue requirements. Thus, SFAS No. 106 would result in the uneconomic, unfair, and unwise use of ratepayer money.

Although SFAS No. 106 does reflect PBOPs costs for external reporting purposes, it has not been embraced by the corporate,

30. Coopers & Lybrand, pp. 52-53.
Employee Benefit Research Institute, pp. 54-55.
Also, see Appendix A-7.

financial, and legal communities as the true measure of an employer's PBOPs costs. Appendix 5 contains various publications that explain the impact of SFAS No. 106 on corporate financial status and that report the actual (non)impact of SFAS No. 106 on major corporations that have already adopted SFAS No. 106 for reporting purposes. Appendix 6 contains copies of utilities labor contracts and data responses which clearly show that PBOPs are not contracted as earned over the working lives of active employees. To the contrary, these documents show that employees qualify for PBOPs upon retirement. DRA surmises that if SFAS No. 106 truly reflected PBOPs costs that 1) it would have an immediate impact on cash flow and credit ratings and 2) it would not be inconsistent with labor contracts and the tax code.

Labor contracts and the contracts between insurance providers explicitly recognize PBOPs as earned when medical claims are incurred and not over the working lives of active employees (Appendix 6). These documents are relied upon by the courts to determine an employers' PBOPs obligation. These arrangements are consistent with IRS/ERISA which allows employers to fully deduct PBOPs on a pay-as-you-go basis and has no minimum prefunding requirements. However, these earnings and funding arrangements are not consistent with the FASB's "Substantive Plan" (SFAS No. 106, paragraphs 23-28).³¹ A "Substantive Plan" is not an existing benefit plan but is an accounting concept which was devised to attribute PBOPs over the working lives of employees in the absence of such attribution formulae in the actual benefit contracts and in the tax code.³² For these

31. It is important to note that this is not the case with pension plans. Pension agreements contain earnings formulae that quantify the amount of pension income earned over the working life of the employee (see Appendix 6). IRS/ERSIA requires employers to incorporate vesting and benefit accrual formulae in their pension plans (ERSIA Sections 201-211).

32. This FASB construct is consistent with the basic accounting principles that define the accounting recognition of costs as not necessarily the same as the legal obligation or funding.

reasons, SFAS No. 106 is only being used for accounting purposes and certainly FASB does not intend it to be used to determine funding or, for that matter, to annul or abrogate existing labor contracts. This Commission should follow the lead of the experts and the courts by not adopting SFAS No. 106 for determining revenue requirements for PBOPs. Only IRS/ERISA accounting provides utilities and regulators with the flexibility to fund PBOPs as they are earned pursuant to the explicit language contained in the labor and insurance contracts. It is these contractual arrangements which truly reflect the nature of the PBOPs and the manner in which they are earned.

Credit rating agencies and financial experts are unanimous in their assessment of the financial impact of SFAS No. 106: SFAS No. 106 has no cash flow impact and, generally, will have no effect on creditworthiness (Appendix 5). These determinations are not knee-jerk reactions but are the professional judgments of agencies and organizations whose reputations were established by making responsible assessments of financial ramifications of such phenomena. Indeed, these official assessments are well-reasoned, logical, and conservative.

Edison has asserted that credit rating agencies have not come to grips with SFAS No. 106; therefore, their official pronouncements should be discarded out-of-hand. DRA believes that such unsubstantiated remarks are self-serving for two reasons. Edison has not presented any evidence that Standard and Poor's, Inc. or Moody's, for example, are unreliable. Indeed, these are the same credit agencies that the utilities and the CPUC has relied upon for years when analyzing and determining costs of capital and rates of return. DRA strongly urges the Commission to give no weight to Edison's argument unless it provides some concrete evidence regarding these credit agencies' lack of diligence and scrutiny.

**5) SFAS No. 106 Results in Cost that are too
Unreliable and Speculative to be used in
Setting Rates**

SFAS No. 106 derived costs are too speculative to warrant rate recovery. If there is one aspect that is certain about the implementation of SFAS No. 106, it is the colossal uncertainties involving 1) the reliability and accuracy of the SFAS NO. 106 representations for nonaccounting purposes (see footnote 9 and SFAS No. 106, paragraph nos. 38-41, 150, 388-389), 2) the long-term dynamics of PBOPs and retiree medical care (SFAS No. 106, paragraph nos. 195, and footnote 9) 3) public policy and tax incentives for providing PBOPs³³, and 4) the inconsistencies between accounting under GAAP and for IRS tax purposes (see footnote 21). This is clearly evidenced by the almost complete lack of funding the total liability, the lack of funding for any portion of the liability, the scepticism with which the stock markets and credit agencies have viewed the new standard, and the aggressive efforts by employers to reduce or eliminate the PBOPs liability before implementing SFAS No. 106. The obvious signal from competitive markets is that the most prudent course of action is not to fund or to fund very little until more of these issues and dilemmas are settled.³⁴

These uncertainties obviously have serious implications for the funding of PBOPs obligations. This is most clearly evidenced by the SFAS No. 106 disclosure requirement for the effect of a 1% change in the health care cost trend rate on the estimate of the annual expense and liability. Furthermore, labor negotiations

33. Employee Benefit Research Institute, pp. 13-17.

34. Health Insurance Association of America, 1990 Survey of Health Care Costs.

Foster Higgins, 1990 Survey of Health Care Costs.
William Mercer, Inc., 1991 Survey of Health Care Costs For California Employers.

Also, see footnote 8.

and changes in utilization and technology can also cause tremendous changes in prefunding levels far beyond anything conceivable with pay-as-you-go accounting. Given this predicament, any possible net savings attributed to switching from pay-as-you-go funding to prefunding can easily be overwhelmed by the compounded costs resulting from routine changes which increase the SFAS No. 106 obligations. This is why credit agencies are not placing much stock in SFAS No. 106.

These facts lead DRA to conclude that regulated utilities should not take the lead in burdening customers with all risks for such controversial and sweeping phenomena. For example, the implementation of this new standard is forcing employers, employees, benefits providers, and legislators to confront major legal, labor, public policy, and regulatory issues which are currently unresolved at the nation-wide level. In this regard, it is absolutely essential to realize that retiree medical care is a city, state, and nation-wide problem. Regulated utilities should not be setting radical precedents for such problems.

By shifting the maximum cost burden and all conceivable risks onto ratepayers now, ratepayers stand a high probability of being mired in an inflexible position and having overcommitted funds. In effect it will be ratepayers who will be left holding the bag as the unregulated markets and legislators work through these external issues, resolve horizontal and vertical equity issues, stabilize PBOPs and prefunding levels, and find the optimal solutions. This result is a classic case of in which a dominant supplier forces captive customers to assume, unnecessarily and unfairly excessive costs and risks.

Regulators should encourage shareholders and utility management to follow the lead of competitive markets whereby funding decisions are the result of thorough and rigorous economic analysis. Thus, the CPUC should adopt a prudent and conservative approach to prefunding PBOPs. To do otherwise would bias the regulatory equation by unfairly burdening ratepayers with excessive costs and risks.

**6) Adoption of SFAS No. 106 Will Preclude
Alternative Courses of Action for Both
Utilities and Regulators**

Adoption of SFAS No. 106 will constitute total commitment to a radical position which will preclude the alternative courses of action available to firms and regulators adopting a more conservative and prudent stance. If SFAS No. 106 is adopted for ratemaking treatment, then, by definition, this Commission will allow utilities to assume the entire PBOPs liability and charge ratepayers for the total SFAS No. 106 amounts. Given the issues and uncertainties to be resolved, and the reluctance of competitive markets to embrace prefunding (to any significant extent), adoption of SFAS No. 106 would place utilities and ratepayers at a serious and potentially disastrous disadvantage.

**7) Prefunding Nuclear Decommissioning Costs
Is Not A Relevant Precedent**

Nuclear decommissioning sinking funds are not a relevant precedent. DRA notes that the California Public Utilities Code does not include statutes on pensions or PBOPs. The Public Utilities Code does include statutes on funding requirements for the decommissioning of nuclear facilities.³⁵ Pensions, SFAS No. 106 and decommissioning funding share some conceptual similarities: all must currently recognize the expense of liabilities that will not come due for a considerable time; the long lag time creates uncertainty about the expected cost. The California Nuclear Facility Decommissioning Act requires a utility to set up an externally managed, segregated sinking fund which qualifies for a tax deduction under IRC 468A.³⁶ No such requirements for external sinking funds are required for pensions or PBOPs. Public health and safety, environmental impacts and national security are the primary issues that justify sinking fund treatment. These do not apply to PBOPs or pensions. Therefore, it is inappropriate to compare nuclear decommissioning to pensions or PBOPs, especially on a net present value basis.

35. Cal. Pub. Util. Code secs. 8321 - 8330.

36. Cal. Pub. Util. Code sec. 8325.